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Trade Liberalization and the Transition to a Market Economy

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Trade liberalization is more important to Eastern and Central European economies than to reforming nonsocialist economies — and will also benefit the reforming socialist economies more. But it must be accompanied, or quickly followed, by rapid privatization.

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This paper -- a joint product of the Trade Policy Division, Country Economics Department and the Trade and Finance Division, Technical Department, Europe, Middle East, and North Africa Regional Office — is part of a larger effort in PRE to examine questions relating to the transition from a socialist to a market economy. Copies are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Nen Castillo, room N10-033, extension 37961 (51 pages).

The fundamental issues in trade liberalization are how, how much, and how fast to liberalize. Experience outside Eastern Europe indicates that speed is important and reform should go as fast as political circumstances allow, so opposition cannot build up and reverse the process.

The real reason for speed is that a big bang automatically meets the criteria for successful reform: the credibility that derives from a comprehensive, coordinated reform package and a clearly preannounced statement of the content, schedule, and goals of the reform program. If these conditions can be met under gradual reform, gradual reform should work — but rarely is that true, and the instances of failed or partial reform are many.

Reforming socialist economies should accelerate rather than retard the pace and phasing of trade liberalization because, compared with other developing countries, these countries have:

- Far more price distortion.

- More poorly functioning or nonfunctioning factor markets.

- A more concentrated domestic production structure, with associated lack of domestic competition.

Consequently, it is only through trade liberalization that a rational price structure can be achieved during the transition.

Trade and other reform will not succeed without rapid and widespread privatization. Without privatization, the resource reallocation and supply response to trade liberalization will be less vigorous (in state-owned enterprises) and it will be necessary to maintain central government checks (such as wage controls) on the perverse behavior of decentralized firms without owners.

But even if widespread privatization of large state enterprises occurs with a lag, trade liberalization should proceed rapidly for the following reasons:

- The political environment is now favorable for trade liberalization. Failure to seize the opportunity to liberalize trade might create a permanently protected economy, as politically powerful interests are likely to emerge who will want to maintain protection in their sectors.

- The supply response from small and medium-sized firms, which can be privatized almost immediately, and from large private firms created by foreign direct investment — should be strong.

- Better price signals will improve resource allocation even in state-owned enterprises.

- Trade liberalization often complements, and therefore accelerates, the privatization process.

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THE ROLE OF TRADE LIBERALIZATION IN TRANSITION TO A MARKET ECONOMY[1]

I. INTRODUCTION

The focus of this paper is on the transition from a trade regime in a socialist economy to one based on a (more) liberal market economy. Thus, there is no need to detail the past and current nature of trade institutions, patterns and performance. However, the sorts of problems that a transition policy must address emanate from the initial conditions. We begin with a brief stylized statement of well-known and largely agreed upon facts about these countries' trade.

1. Trade has been highly distorted by government controls, and has likely been skewed to varying degrees towards trade within the CMEA. (Chart A)
2. Partly as a result of the above, and partly as a consequence of the heavy industry and self-reliance orientation of the central-planning period, the export structure has been skewed somewhat towards machinery and equipment to CMEA, capital and material intensive exports to OECD (steel, petrochemicals, fertilizers) (Table A and Chart B).
3. Trade performance has been poor and deteriorating for well over a decade.[2]

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[1] The authors would like to thank Ulrich Thumm, Refik Erzan, Manuel Hinds, Fernando Saldanha and Alfredo Thorne for helpful comments, Michael Termaat for research assistance and Nen Castillo, Rebecca Sugui and Martin Yokum for secretarial support. An earlier version of this paper was presented at the OECD/World Bank Conference "The Transition to a Market Economy in Central and Eastern Europe," Paris, Nov. 28-30, 1990. The views expressed are those of the authors and do not necessarily reflect those of the World Bank.

[2] Konovalov (1989) details this poor performance for Poland.

4. With the exception of Yugoslavia, trade policy has been based on a number of central-plan tools such as directives, price-equalization funds giving different effective exchange rates for hundreds if not thousands of products, foreign exchange surrender, central reallocation and licensing. Tariffs are low, but protection is very high from the combination of the central-plan tools used.

5. Until 1989, only Yugoslavia, Hungary and Poland attempted to decentralize and liberalize trade, but in all cases the programs were limited , partial, and on the whole unsuccessful whether measured by reduction of restrictions or export performance.[3]

With these initial conditions, all these countries have expressed a commitment to liberalize substantially not only their trade, but the entire economic system, including replacement of planning with the market, and of state ownership with private. The question before policy-makers is three-fold: how to liberalize, how much to liberalize, and how quickly to liberalize? One might say the last question should be answered first, for if the choice made is as in Poland -- immediately and with a Big Bang -- the other two questions are moot. This is not quite correct, for either explicitly or implicitly, the decision to adopt the "Big Bang" approach must be based on the judgment that the gradual and partial transition alternatives are inferior.

An additional constraint has been imposed on the situation: the decision of the USSR-already partly implemented-to eliminate the advantageous pricing of its raw material exports in the CMEA area. The import-cost burden of this could not have come at a worse time, and it has been further exacerbated

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[3] Havrylyshyn, Chapter 3 of Roy and Roe (1989) gives a general comparative picture for the three economies that have attempted some degree of trade reform.

by the Gulf crisis. Of course, these adjustments costs must be borne by those countries who are liberalizing as well as those in the CMEA area who are not, and therefore should not be attributed to the market liberalization measures.

Given these initial conditions, constraints and desires, a number of issues have arisen, often expressed as concerns about the difficulty of implementing trade liberalization. We list here the five main ones.

1. How should one deal with the unemployment resulting from trade liberalization, in particular since the unemployment will in any event increase with the market transition?

2. Has a technology and quality gap evolved between the "soft" goods Eastern Europe produces and the "hard" goods Western markets demand which may require considerable time to close?

3. Widespread privatization is necessary for the achievement of a market economy. If widespread privatization is not yet in place, won't trade liberalization result in excessive transition costs that will cause a reversal? On the other hand, while substantial for investment is needed to supply the financing, technology, and expertise required for this transition to hard goods is there not a great risk of selling-off assets to foreigners at under-priced values?

4. Does the terms-of-trade shock make this a difficult time to liberalize imports without substantial balance-of-payments stand-by support?

5. In all cases but one--the Czech and Slovak Republic-- substantial macroeconomic imbalances still need to be corrected. Wouldn't too-rapid trade liberalization simply worsen this?

This is the pessimistic interpretation of the problems confronting policy. Not eve. one shares these concerns, or interprets each of the issues in so pessimistic a fashion. But the issues listed do represent the main areas of policy conflict or trade-off that need to be resolved in order to decide finally how, how much, and how quickly to liberalize trade. The present paper presents a framework in which these issues can be analyzed, and in some cases already suggests the resolution of these apparent conflicts. It draws upon the experience of trade policy regimes and their reform in the developing world, including the recent experiences in Eastern Europe.

Part II of the paper outlines the framework of trade policy, noting the role trade plays in development, the main elements of the policy package, and their relation to the overall economic policy picture. Part III summarizes the main conclusions from trade liberalization experiences worldwide, includes some discussion of their applicability to formerly-socialist economies, and discusses external constraints and opportunities presented by GATT and the Uruguay Round and relations with the EEC. Part IV. focuses on the nagging question many have about liberalization (in general, not just of trade): what if any is the role of government in a liberalized economy? Finally Part V concludes by presenting and analyzing the principal differences between Eastern European countries and others regarding trade liberalization, and discusses how the generally advised path toward trade liberalization would be altered in Eastern Europe.

II. A TRADE POLICY FRAMEWORK

The Role of Foreign Trade

A sensible trade policy is not an aim in itself, but one of the tools used to promote economic development or "equitable economic growth" as

Fischer and Thomas, (1990, WPS 459) define it. That higher and more equitable economic growth tends to be associated with higher growth of exports and increasing share of trade in GNP, is generally accepted. (Thomas, Matin, and Nash 1990). That more outward-oriented trade policy gives clearly better trade performance is also quite widely accepted, (Edwards, 1989). Analysts appear to disagree still on whether outward-orientation should be accompanied by import liberalization or be done instead via compensatory export-promotion measures such as duty and tax exemptions for exporters (Sachs 1987, Edwards 1989), but they do tend to close towards a consensus again on the following propositions:

- many more countries have tried and failed to implement outward-orientation by government intervention, than there are countries that have done so successfully.
- even those few considered by some to have done it successfully (Korea, Taiwan), have certainly at a minimum been far less restrictive than others, and have moved steadily and consistently to liberalization.

A more outward-oriented and more open or liberal trade policy contributes three things to economic development:

- a set of rational economic prices for traded-goods that is essential for efficient resource allocation (the comparative advantage story.)
- the competitive pressures that ensure no monopoly inefficiencies arise in small economies, and that push domestic producers to achieve the highest potential efficiency.

- the introduction of better and more appropriate technology through access to foreign investment, equipment imports, and the demonstration effect of imported goods.

We shall argue that these three benefits of trade liberalization are more important and likely to result in greater benefits in Eastern Europe than in other places in the world.

Until recently, econometric estimates of welfare benefits of free-trade had been on the small side, typically about 1 percent of GDP. The methodology measured only immediate, short run gains from the reallocation of resources towards comparative advantage goods, and did not include long-run effects of stimulating productivity and competition. Substantial empirical work in the past decade has increased these estimates to more like 5 percent, and in many cases well above that.

First, the original estimates were for developed countries with relatively low protection levels. The same arithmetic that gave 1 percent gains for eliminating tariffs of about 10 percent, gives much higher gains when tariffs were, as in most developing countries, 40 percent and more. This is because the costs of protection rise more than proportionately with the tariff, because the "welfare triangle" of costs has both its base and height increase with the height of the tariff.[4]

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[4]The height of the triangle is the wedge between domestic and world prices (determined by protection such as the tariff), and the base of the triangle is the change in quantity induced by the protection. With no change in the elasticity of demand, the change in quantity demanded acts multiplicatively on the price wedge in assessing the distortion costs of protection.

Second, analysis of more detailed interaction effects (notably including imperfect competition) through micro, firm level analysis has provided some estimates of the competitive efficiency, scale efficiency and technology gain effects.[5] The results showed these two effects tend to be multiples of the resource allocation gains, reaching well over 3 percent and frequently about 10 percent (a review of this work is in Havrylyshyn (1990, WBRO).

Further, the new growth theory [most notably Romer (1988, 1989)] has established a causal link between openness and more rapid growth. Very briefly summarized, new techniques and technology are required to provide a temporary boost to growth. Since the immutable law of diminishing returns applied to the new technology implies that returns to scale on the new technology will eventually become constant, it is necessary to have a continuing infusion of new techniques; otherwise per capita growth will be zero. A closed economy will have to rely on its domestic research and development alone to achieve growth. An open economy can import new technologies from the entire world. For a small economy the difference will be enormous. Thus, the association between exports and growth noted above, may be causally related to the fact that it is necessary to export in order to import, i.e., growth is "import-led."[6] Early efforts at quantifying

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[5] Although microeconomic studies of the costs of protection in Eastern Europe are virtually nonexistent, Tarr (1990b, 1990c) has shown that the complicated maze of regulations in the Polish butter market inhibited export performance, while at the same time, restraints which discouraged imports encouraged costly production of autos and color televisions.

[6] This idea goes back to John Stuart Mill, but Romer's contribution was to formalize it. On the other hand, Krugman (1988) has developed a model of export-led growth. One sometimes speaks of socialist economies growth in the seventies being "forced import-led," which of course does not give the efficiency effects Romer describes, because without the appropriate price signals to direct imports or incentives within the firm for efficient performance, the wrong goods are imported and poorly absorbed. In fact, Terrel (1990) and others have shown empirically that because of the lack of appropriate incentives, Polish and Soviet firms which imported Western

the growth effects of trade liberalization (for example, Baldwin, 1989), have suggested that the benefits from increased growth are several times the static benefits mentioned above.

Let us conclude by considering the common popular view of the role of foreign trade providing for "essential" imports. Too frequently, this view provides a damaging rationale for highly restrictive trade policies aimed at achieving self-reliance. No one familiar with centrally planned economies needs to be told that most economies are technically capable of producing just about everything, but those that try do so at a very high cost and with poor results in quality as well. If foreign trade is allowed to allocate resources efficiently in response to rational world prices, this provides the export earnings that pay for imports of "essential" goods.

The Components Of Trade Policy

Perhaps the most important component of a trade policy is the exchange rate, both in the sense of the level of a single exchange rate and in the sense of the legal arrangements of foreign exchange operations. A change in the level of a uniform rate immediately changes the competitiveness of exporters and those competing with imports, and hence affects trade flows. More complex arrangements of multiple rates, full or partial surrender of export earnings, priority schemes for allocation of foreign exchange distort the relative price structure of traded goods. (See Tarr (1990a) for a quantification of the impact of various exchange rate policies in Poland in 1989.)

The central planning tradition has utilized administrative, nontariff barriers more extensively than tariffs. Tariffs are more pro forma and generally

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technology did not perform better than those which used domestic technology.

very low -- the source of an important transition problem for at least some countries, those which are members of GATT. A first major step in liberalizing a highly protected economy is the often relatively painless elimination of quantitative restrictions and retention of the high tariffs giving roughly equivalent protection. The high protection of socialist economies would fall immediately unless tariffs were to be raised, a procedure GATT membership frowns upon. But the problem is perhaps overstated. First of all, if a Big Bang is chosen as the best policy path, the tariff average chosen might be, as in Poland, lower than the previous implicit protection albeit still higher than the OECD average. Secondly, both the GATT rules and the political sentiments allow for the possibility of temporary increases in low tariffs. And third, not all countries are that tightly constrained by tariff bindings agreed upon earlier. (See Part IV)

A bigger concern should perhaps be with the temptation of policy-makers in Eastern Europe to try "new" nontariff barrier tools, as a means of easing the transition to an open economy. The lessons of those few that have done so in their partial -- reform attempts (Yugoslavia, Hungary, Poland, as summarized in Roy and Roe, (1989)), as well as the experiences of other developing countries warn against this approach. All tools other than tariffs have the same characteristics as central-plan trade policy: they are highly distortive of price relations, ad hoc and subject to favoritism, corruption and rent-seeking. Most important, they are non-transparent and thus escape the scrutiny of the market and the voters.

Coherence of Trade and Other Policies

While the small size of Eastern European economies highlights the importance of trade and trade policies, trade liberalization cannot stand alone, but must be part of a much broader program of liberalization. A more interesting set of questions may be put as follows:

: should trade liberalization await stabilization?

: what are the most important links between trade and other policies?

Part III will return to these two questions, illustrating the experiences of trade liberalization and their interplay with other policies.

The list of liberalization or transition policies can be fairly long, and economists writings on this have mushroomed. Two items of particular usefulness on this are Hinds (1990) for its readable thoroughness, and Sachs (1990, Economist) for its succinctness. One might distill recent writings on this to five broad elements (see Box 1).

The first four elements together create an environment of competition in the economy; the last two assure international competitiveness. Note that opening up via trade and foreign investment liberalization plays a role in assuring both domestic competition and international competitiveness. In a very large economy, one could in principle have lots of internal competition within a highly protected economy. In smaller economies, liberal trade policies can buttress anti-monopoly regulations, or indeed make them unnecessary except for non-traded goods such as transport, communications, energy distribution.

A remark is in order about privatization. There is a growing consensus that rapid privatization is absolutely essential to the success of the reforms in Eastern Europe. Although it is difficult to place an exact date on how soon the privatization must occur, if it does not occur within two or three years of

Box 1. Five Key Components of Transition

DECENTRALIZATION OF ECONOMIC DECISIONS.

-- elimination of central-planning

-- enterprise freedom on production, pricing, investment, labor, and use of profits, or responsibility for losses. As Hinds, Saldanha (1989) and others have argued, this must be accompanied by rapid and widespread privatization or it is likely to be counterproductive.

INTRODUCTION OF MARKET SYSTEM

-- rapid privatization of a very significant share of the economy; this can only be accomplished by a rapid privatization mechanism, as opposed to the valuation of the assets and subsequent sale of the firms.

-- free pricing of goods plus monopoly regulation rules in some cases (although import competition is superior to antimonopoly regulation for goods, regulation is appropriate for nontradable services)

-- establishment of capital markets including banking and other financial institutions

-- free labor markets plus unemployment safety-nets as substitutes for job-security of central plan

FINANCIAL DISCIPLINE

-- Government fiscal and monetary stabilization, including establishment of autonomous Central Bank

-- Firms: elimination of soft-budget subsidy world via some combination of privatization and hard-rules for state-enterprises

OPENING TO GLOBAL ECONOMY

-- trade liberalization and attendant outward-orientation

-- foreign investment liberalization

EXCHANGE RATE RATIONALIZATION

-- establishment of single uniform rate and elimination of retention quotas, priority allocations, equalization transfers

-- devaluation (theoretically one might say: "setting equilibrium rate"; but in practice this invariably means devaluation)

-- internal-convertibility leading to a free market for foreign exchange the start of other widespread reforms, including trade reform, the reforms are likely to fail. Inadequate incentives within the firm to respond to the "improved" signals from the market will cause the transition costs to be excessive and result in a reversal of the reforms. Since the case by case approach of valuing the enterprises and subsequently selling them is extremely time and talent intensive, such an approach is impossible where rapid privatization of thousands of enterprises is required.

Some analysts object to <u>immediate</u> privatization due to the view that "effective" and "fair" privatization cannot be achieved immediately, and this view creates fears especially regarding the large enterprises. There are, however, a number of rapid privatization proposals that address the fairness issue,[7] so that one is left to question whether it is really a matter of political will to create capitalism that results in slow privatization. Even if unfairness is a problem in the short-run, the uncertainties and possible unfairness of privatization may be less costly than the risk of continued soft-budgets and the lack of incentives for managers to act as entrepreneurs. Certainly, experience shows politicians find it particularly difficult to insist on financial discipline of state-owned enterprises when faced with massive job-losses. Finally, to say that privatization cannot be completed immediately because of the difficulties of setting up stock markets and related institutions does not mean it should not start immediately. New small scale enterprises in service and even manufacturing should be allowed, as should sale of retail and service establishments. The biggest problems occur with large industrial and infrastructure entities. We return to the relationship between privatization and trade liberalization in the concluding section.

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[7] There are the proposals by Hinds and by Sachs, as well as the voucher proposal of the Czech and Slovak Finance Ministry. See Milanovic (1990) for a survey.

One can for convenience think of the causality between trade and other policies in both directions: the effects trade policy has on the rest of the package, and vice-versa. For the first, the most important impact of trade policy throughout the economy is in two areas: providing a price structure for a newly freed market, and (related to it) offsetting possible monopoly effects, especially in small economies. Indeed the smaller the economy, the more important it is to have trade liberalization come quite early. This must mean tariffs rather than other forms of protection, and tariff rates that are not high. Furthermore, the more uniform the structure, the closer to a single tariff rate, the better for the purpose of providing very quickly the new correct price structure. As Fischer (1990, comment on Lipton and Sachs op.cit.) puts it in reference to Poland's overnight importation of the world price structure: "The importance of this change cannot be overemphasized, for it answers the question of how a reforming and heavily distorted socialist economy can move to an appropriate price structure."[8]

Trade liberalization is the most effective anti-monopoly tool for goods, and requires little complexity of laws, regulation and control. Where nontradable sectors such as nontraded services and wholesale and retail trade are concentrated some anti-monopoly legislation is appropriate. These latter sectors, however, are often the least concentrated, and therefore least in need

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[8] Fischer goes on to say this approach can be useful for all East Europe, but less so for the Soviet Union which is more closed and will remain so by virtue of its size. But the discipline of an appropriate price structure imported through international trade is essentially independent of the size of the economy, because all firms must compete with the international prices. Even if the share of trade is small, firms cannot charge a price greater than the import price, so the international price becomes the marginal cost of production. Moreover, the size of the benefits is related more to the degree of distortion of prices than the share of trade; and distortions in USSR are probably at least as large as in Central Europe.

of anti-monopoly legislation. More importantly, there is a significant risk that anti-monopoly legislation will be counterproductive because: (1) by divesting firms of plants or operations, it may prevent the achievement of economies of scale and scope, which are fairly widespread in industry (see, for example, Pratten, 1987). A large economy such as the US will generally be able to have multiple plants and companies in industries with economies of scale or scope, but the Eastern European countries will experience greater costs from deconcentrated production;[9] and (2) anti-monopoly legislation generally extends into the area of laws against predatory pricing, which experience has shown occurs extremely rarely in relation to the number of times it is alleged, and too often prevents healthy competition (see, for example, Carlton and Perloff, 1989, ch. 13; and Koller, 1971). Thus, trade liberalization is the preferred anti-monopoly instrument in small countries.

In the other direction, the most important internal liberalization needed to support the effectiveness of trade policy is privatization and the elimination of soft-budgets, without which the incentives to respond to export opportunities or import competition are not present. Also, the stabilization of both fiscal and monetary imbalances is essential inasmuch as inflation creates uncertainties, and government deficits usually (though not necessarily in theory) lead to current account deficits. No amount of micro incentives to export or compete efficiently against imports will close a current account gap that results from excessive public consumption and inadequate domestic savings. Finally, it goes almost without saying that sensible exchange rate management -- at a minimum

[9] An argument can be made, however, for divestiture of vertical and conglomerate relationships which provide little economies of scale benefits and are often extremely pervasive by Western standards. If companies do not compete at the horizontal level, however, then we can expect small benefits in terms of competition from their divestiture.

allowing needed devaluations and unifying multiple rates -- ideally immediate current account convertibility -- is an important complementary requirement to yield the expected benefits of liberalization.

Coordinating Multilateral, Regional, and Bilateral Trade

The fundamental principle of good trade policy is neutrality, or the avoidance of distortions, discriminating one type of good in favor of another.[10] The neutrality principle applies as well to trade policy with different partners. The non-discriminatory clauses of GATT are not a simple matter of moral or political fairness, they are good economics. Although the exceptions to those clauses may have historical and political value as necessary evils, on economic grounds individual countries should rarely practice discrimination. Indeed this should be most evident in East Europe where the CMEA arrangements have been recognized as creating the fundamental distortions which will aggravate the wrenching adjustment of these economies.

There are three principal issues in the area of external trading arrangements.

- what to do after CMEA
- what sorts of regional or bilateral agreements to undertake such as EEC Association and membership
- how to deal with the immediate problem of very low bound tariffs which preclude substituting tariffs for QRs.

[10]Although one can find theoretical arguments for non-neutrality in trade taxes (Ramsey optimal taxes), the political economy argument for neutrality is probably the strongest. In practice non-neutrality results in high rates of effective protection for domestic final goods producers with low rates of protection for inputs not produced domestically.

Trade and payments arrangements after the dissolution of the CMEA are discussed at length in the paper by Michalopoulos and Tarr in this volume, and will not be repeated. Here one may note only that the pain caused by terms of trade will be entirely a loss if it is not accompanied by sorely needed adjustment toward the introduction of market forces in the nature of the trade and payments arrangements of these countries.

There is the opposite risk that the prospect of a favorable deal with the EEC may lead Eastern European countries to forsake multilateralism. The orders of magnitude of export gains from removing EEC barriers are still being calculated and debated, but early estimates for Hungary show this to range from 6 percent to as much as 40 percent of exports assuming full membership (Tovias and Laird, 1990). Tovias and Laird estimate that the Uruguay Round success alone without special treatment would increase Hungary's EEC exports by over 8 percent, and the special treatment of 6 percent, (same as GSP) would together with Uruguay Round effects give 13 percent. This clearly shows there is much is to be gained from multilateral pressure on EEC barriers. Moreover, it is perhaps only through multilateral negotiations that agricultural distortions will be reduced; otherwise closer alignment with the EEC system may lead to increased distortions in East and Central Europe.[11]

Finally, the problem of GATT restrictions on renegotiating tariffs upward are not that constraining. Article XXVIII provides ample legal room for this. The question may be moot in cases where the decision is to follow Poland's example and not only remove nontariff restrictions, but also to cut the tariff

[11]Of course, developing country interests are not homogeneous in the GATT. For example, while Hungary is a member of the Cairns group of countries that favor a reduction of agricultural subsidies, the "Net Food Importing Developing Countries," are seeking compensation in the event that the Uruguay Round reaches agreement on the reduction of agricultural subsidies.

to a fairly uniform low level. Although a low tariff level is optimal, if for some reason this does not happen and higher tariffs and gradual reduction is decided upon, tariffs are strongly preferredt to NTB's. East Europe could renegotiate tariffs upward in exchange for elimination of NTB's as a second best option.

III. TRADE LIBERALIZATION EXPERIENCES HISTORICALLY

General Findings

There are many trade policy options, from autarky to free-trade, and the first role of government is to choose the policy that will best foster a country's economic development. Traditional economic theory favors positions as close to free trade as possible, while a competing proposition, support for infant-industry, favors import substitution at an early stage of development. The historical evidence tells us a great deal about which policies are better.

Within this debate, there is broad agreement on one point:

sustained rapid export growth is good for economic growth.[12]

Almost all studies relating exports to economic growth, from Balassa (1978), to Thomas, Matin, and Nash (1990), agree that in general higher growth of exports is associated with higher economic growth.[13]

The question for trade policy is what kinds of trade regimes result in good export performance. On this issue, too, there is now wide agreement on the following proposition:

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[12] Short bursts of exports, due either to fortuitous circumstances of high demand for a country's raw materials or heavy subsidization of exports, is not in itself enough to sustain the growth impetus.

[13] As noted above, the new growth theory attributes the causality for growth with imports, for which it is necessary to export. There is still therefore an open debate on the direction of causality.

"countries that have relied on 'outward-oriented' policies have done better over the medium and longer-run than those countries that have adopted 'inward-looking' strategies." (Edwards, 1989)

There is less agreement on the appropriate balance between government intervention and reliance on market mechanisms. Trade liberalization usually involves a movement from too much and the wrong kind of government intervention to more reliance on markets. In particular, it involves two elements: correcting the effect of distortionary interventions that protect domestic industry against competition from imports and consequently result in an anti-export bias; and reducing the degree of government intervention, allowing markets and prices a greater role in affecting the economic decisions of producers.[14] But while correction of the anti-export bias follows naturally from a substantial reduction in intervention through liberalization of import restrictions and devaluation of the exchange rate, the shift to an outward orientation has often begun with the introduction of new intervention measures to compensate exporters for the high production costs they face as a consequence of import restrictions. Such measures typically include devaluation, but also duty-free and easy access to imported materials and components, export subsidies or credits, assistance in marketing, and so on.

Outward-orientation can be achieved either by less government intervention or by different government intervention. But in the long-run, the evidence shows that very high and continued intervention by governments is damaging to the economy and to trade performance.

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[14] Krueger (1978) and Bhagwati (1978), Balassa (1971).

While on free-trade itself history tells us almost nothing -- apart from the experience of Hong-Kong, there are no cases to analyze -- the phenomenal success of East Asian countries (from Japan, to the NIC's, and more recently to Thailand and perhaps Malaysia) has provoked disagreement on the appropriate role of government in achieving outward-orientation.[15] Are export-expansion measures that merely compensate for still-remaining import restriction sufficient or must government restrictions and intervention also be reduced? While it is true that Japan, Korea, and Taiwan did not immediately reduce their import restrictions when they began their export drives, they did not permanently maintain extensive government intervention but moved gradually to reduce it. All these countries steadily reduced their import regulations -- Korea more slowly than the others, Singapore and Taiwan more quickly -- starting with decreased reliance on quotas and other quantitative controls and greater use of tariffs, and continuing with reductions in these tariffs. Furthermore the initial levels of protection and distortions caused by government intervention, while high, were much lower in these countries before reform than in most other developing countries.[16]

Clearly then, these East Asian success stories are not examples of a movement toward outward-orientation through new government intervention alone. Rather, they first moved quickly to outward-orientation and then moved slowly but consistently toward lessened government intervention, and in this respect their experience clearly demonstrates liberalization. "Liberalization" is a process over time, involving both a shift to outward-orientation and a reduction of

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[15] See Sachs (1987) and Lal and Rajapatirana (1987) for different interpretations, and Edwards (1989) for a reconciliation of the two.

[16] See Krueger (1978).

government intervention. We return later to the issue of the speed of the liberalization process, arguing in particular that few countries have been able to liberalize as gradually as Korea and without losing momentum.

Another area of wide agreement in the liberalization debate is on the need for an appropriate exchange rate policy.[17] Devaluation, by increasing the value of exports and the cost of imports, corrects the anti-export bias of an economy and contributes to both export expansion and efficient import-substitution.

Minimizing the Transition Costs of Liberalization

Liberalization is often said to entail many costs.[18] Workers in formerly protected industries may lose jobs as a result of import competition, and export expansion may be slow to come as exporters may be slow to respond to the new opportunities; and the devaluation that accompanies liberalization raises costs and may add to inflation. While all of these problems may accompany liberalization, they are not always as severe as feared and they can be managed by appropriate government policies.

Where devaluation is necessary (and it usually is), it will indeed raise prices, but this effect is offset by the lower prices on imported goods as import restrictions are reduced. Also, devaluation is a far less important cause of inflation than overall macroeconomic instability. So an even more important complementary policy is to ensure macroeconomic stability through fiscal and

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[17] See Michaely, Choksi and Papageorgiou (1987) and Thomas, Matin and Nash (1990) for discussions of the great importance appropriate devaluations have in explaining successful experiences of trade liberalization.

[18] The following discussion draws heavily on the recent Bank report by Thomas, Matin, and Nash (1990).

monetary restraint. Also on the positive side, devaluation makes domestic producers more able to compete with imports, and by allowing for more efficient import-substitution, reduces the employment effects of increased imports. Finally, one needs to be clear about what prices are increased by devaluation and for whom. If the exchange rate was overvalued before the devaluation, the resulting foreign exchange shortages meant that not everybody could buy the imported goods; while some were privileged enough to receive centrally allocated foreign exchange at the official exchange rate, some paid a premium price on the black market and some went without. Devaluation means higher prices only for those who previously had foreign exchange allocations. Those who were unable to buy certain imports because of shortages may now be able to do so while those who paid black market prices continue to pay those prices (or lower ones) but can buy the goods openly. In fact, devaluation, by encouraging exports and thereby earning additional foreign exchange, will reduce the black market price of foreign exchange. (See Tarr 1990a for quantification for Poland.) Thus, higher prices after devaluation are dependent on the buyer.

An exactly analogous illusion applies to price liberalization in transition economies such as Poland's Big Bang. As statistically measured prices have outpaced wage increases, so the standard of living is said to have fallen. However, the low controlled prices were meaningless to the extent buyers could not obtain the goods at that price. That is the essence of a shortage economy. Parallel market prices in 1989 would be a better base to use for comparison with free market prices today. The standard of living decline would doubtless be far lower.[19]

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[19]See Tarr (1990c) for a quantification of the welfare effects of devaluation on the Polish auto and color television markets and Lipton and Sachs (1990) for a further elaboration of these views.

Trade liberalization will result in some worker dislocation, which may even be quite high in some localized areas or sectors. But its overall extent throughout the economy has been exaggerated, as a recently completed Bank study of 19 countries has demonstrated.[20] The study found that two factors minimize the unemployment problem. Of all the liberalization cases studied, only that of Chile in the mid-seventies showed unemployment effects as high as 10 percent. But this occurred only for manufactures and was offset by the very rapid employment expansion in processed agricultural exports. As liberalization measures shift the economy toward an outward orientation and reduce anti-export bias, export expansion also increases employment. And in developing countries, export activities tend to be much more labor intensive than import-substituting ones.

East European-economies having been overly concentrated on manufacturing (Table A), and capital-intensive manufacturing at that, the trade adjustment should be even more strongly labor-creating. If one considers further the existing low share of the labor-force in services (Table 2), the expectations for a lot of labor-intensive output expansion are enhanced even more. A recent survey of the service sector in Socialist Economies [Zienkowski (1990)], shows the share of employment is as much as 10-15 percent lower than for economies with comparable per capita income.

It is interesting to observe casual indicators of activities where new foreign investment has already come, and where it is being hesitant. Commercial press reports abound on deals in Hungary and Poland for home electrical goods, tourism booms or boomlets, Poland's vaunted film/cartoon industry. Coverage also

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[20] Michaely, Chokei and Papageorgiou (1989).

exists on the inability to strike deals for many of the capital intensive heavy industries.

Another important lesson from earlier experience is that dislocation costs are usually low because liberalization has not meant entire factories and sectors suddenly close down, and new ones begin to be built up only slowly. Rather, much within-sector and even within-firm adjustment occurs. While some closures do occur, the bulk of adjustment takes place by reducing production of some goods and increasing that of others, for example, by switching from one kind of steel product to another. Turkey's steel industry before the liberalization of the eighties was highly inefficient, but Turkey has since become a significant steel exporter, thanks to a simple switch from big heavy steel products to simpler products such as radiators for the U.K. market.

In East Europe, this issue of switching product lines and markets is often viewed pessimistically because the soft goods orientation makes the transition to the hard goods demanded by the western markets difficult. Although some firms or even industries will have to close, there are two exaggerations here. First, the dichotomy "soft-hard" is not a useful one, for quality of goods is a continuum -- especially so for consumer goods, but even for capital goods. Auto buyers do not choose only between "simple" and "luxury" models, but from a vast array progressing from the first extreme to the last. Consumers shopping for clothing and household goods in the West do not all buy at high quality name brand boutiques, but in a vast spectrum of price and quality. While the technology and quality gap East European producers suffer vis-a-vis the top end of Western products may be immense, what matters for transition and adjustment is the size of the gap vis-a-vis the bottom end. Inasmuch as existing East European exports already participate at this end of the spectrum and many Eastern

European firms are already selling in both the CMEA and the Western markets, the evidence suggests less of a gap than the conventional wisdom would indicate. Second, the ability to shift production quickly is already being tested. It may be too early to conclude anything definitely, but casual empiricism lends some clues: Polish and Hungarian firms that exported to CMEA have been redirecting their goods to Western markets in the past year. It is necessary to perform some quick studies of who are the exporters to the West, does the same firm export in both directions, and is this done by producing on separate assembly lines, or on separate days? Who are the new exporters?[21]

The concern that export expansion may not come soon enough is valid but again exaggerated. A combination of devaluation and export-promotion measures will help to bring this expansion about more quickly. Note the sharp expansion of exports in Poland in the first three quarters of 1990 after the devaluation of January 1990. Barriers in importing countries are unfortunately a fact of the trading environment, especially for labor-intensive goods and agricultural goods, the main exports of most developing countries. But this is a problem for reciprocal negotiations both bilaterally and at the level of the GATT. This process requires greater and not less involvement of developing countries (including East Europe), as domestic trade policy measures cannot do much to alleviate the constraint of import barriers in developed countries. However, it is interesting to observe in this connection that as the nontariff restrictions of developed countries have increased, the most outward-oriented and least distorted economies of East Asia still come out best in export performance.

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[21] In the USSR, the conversion of military factories to consumer goods raises the same supply response issue. Casual evidence is all that exists, but it all tells the same story as that of the Kiev shipbuilding factory Leninskaya, which succeeded in producing within one year hundreds of thousands of home heaters and ranges (Ukraine, June 1990).

<u>The Pace of Liberalization and its Phasing: Lessons from the Experience of Developing Countries</u>

The desirable pace of liberalization is a much debated question. Any sensible answer must recognize another element besides speed, however, and that is the combination and sequencing of the many concrete policy measures that constitute liberalization.

> **<u>In general, a pace as fast as the political circumstances permit is desirable, but perhaps more important than speed is to avoid piecemeal experiments in favor of a preannounced, comprehensive, and consistent program phased in over a specified period of time</u>.**

A "fast" program of liberalization does not usually mean immediate or overnight, just as most proponents, of "liberalization" do not mean free trade, but allow for possibility of some tariff protection and modest state-supported trade promotion efforts. But swift implementation is advocated because a slow pace gives opponents of liberalization (those who stand to lose from its immediate impacts, like highly-protected capital-intensive industries) time to lobby for political support to reverse the process.[22] The Bank's study of nineteen countries' experience with trade liberalization shows that most reforms fail and that they fail for two reasons: the liberalization is incomplete and so fails to achieve the positive benefits that would justify it politically; and the liberalization is so gradual that political opponents have time to mount a

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[22]The principal argument for a slow progressive liberalization is that if the liberalization schedule is preannounced and adhered to, adjustment costs are likely to be reduced. Capital that depreciates need not be replaced, and workers have time to find new jobs without extended unemployment.

strong opposition.[23] Examples of such failures are Yugoslavia in the sixties, several Latin American countries over the last three decades, and Turkey in the seventies. Starting in 1980, Turkey launched a much more substantial and successful liberalization based on sustained devaluation, a large program of compensatory export promotion measures, advance notification of gradual reductions in import restrictions, and reasonable adherence to the program schedule. By 1990, it removed virtually all its QRs.

There are a few cases of sustained successful liberalization over a long period, such as Korea, Greece, Spain, Portugal. For Greece, Spain, and Portugal, the sustained success of liberalization is explained by the legal commitments they made in their accession to the EEC. The anomaly of Korea's success is often attributed to the political will of its government and the strength of its commitment to a policy of efficient economic growth based on outward orientation -- conditions not found in many other places. But there is another important factor in the Korean case: its strict adherence to sound macroeconomic policies, in particular fiscal and monetary restraint, plus a stable exchange rate which was not overvalued. The Bank studies cited earlier conclude that such complementary policies were the single most important element distinguishing successful liberalization episodes from unsuccessful ones.[24]

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[23] Michaely, Choksi, Papageorgiou op.cit.

[24] Sachs (1987) emphasizes the importance of macro policies in sustaining the export and growth performance of Korea.

A last word on Korea (and much the same applies to Japan[25]): it is widely agreed its success is attributable to outward orientation. But many argue it is an example of government-guided export success and hence "proof" that intelligent infant-industry or industrial policies do work. Even if this is the correct interpretation, its lesson for other countries is not obviously to pursue industrial infant-industry policy. The number of cases of countries that have tried and failed vastly exceeds the two or three alleged East Asian successes of government intervention. Thus, **while one can establish conditions under which infant-industry or industrial policy arguments are valid in theory**, in practice **they generally fail.**

The experience with trade liberalization efforts suggests the following general proposition:

successful liberalization requires that the government maintain momentum and credibility

"He who does not move forward falls backward," goes an old saying; taking small hesitant steps in liberalization and waiting to see the results before taking the next step is a sure recipe for reversal and failure. Bold initial steps (a comprehensive **preannounced** program), and a reasonably fast pace help both to sustain momentum and to lend credibility to the government's intentions. Hesitation and drawn-out programs (with reversals of some measures) quickly undermine credibility and lead to a loss of momentum. The process is self-reinforcing in both directions. What finally, does this say about the pace of

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[25] Heitger and Stehn (1990) have shown that when all incentives are taken into consideration, the industries that received the greatest incentives in Japan were not those who were targeted by MITI's industrial policy for growth. Rather relative subsidies were awarded more on the basis of traditional political economy considerations. That is, even in Japan, designed industrial policy did not lead to its growth.

trade liberalization? In principle, if momentum and therefore credibility can be assured, the process can be gradual.

The experience of two socialist economies that liberalized their trade to some degree prior to 1989 -- Yugoslavia and Poland -- has three principal implications.[26] First, lack of accompanying sustained devaluation almost ensured failure of the policies. Indeed, in both cases, eventually the real exchange rates appreciated at the same time as some export promotion and mild import liberalization measures were in place. Second, the degree of correction of distortions and anti-export bias was far too limited to have substantial effect on export performance. And third, the slow and uncertain pace of liberalization not only failed to gain credibility of producers, it in fact undermined this credibility. As far back as the 1965 reform in Yugoslavia, the opportunity was missed for a strong liberalization when enough consensus existed. Consequently, the pressures of allegedly affected industries almost immediately led to reversals, recomposition of ad hoc protection and a failure of the reform.

IV. THE ROLE OF GOVERNMENT

We turn in this section to the question: what is there for a government to do, if the objective of liberalization is to reduce government intervention? There is a substantial role for the government to play in the process of liberalization, in the transition from inward-looking, restrictive policies to outward-oriented, liberal ones. But even after liberalization is well under way, there remain several critical functions for government in supporting a market-oriented, open, and competitive economy.

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[26] Havrylyshyn 1990 in Roy and Roe (1990) and Konovalov (1989).

Role of Government in Managing the Liberalization Process

The first action of government is to identify the objective of liberalization: given the country's current trade regime, where does it want to go? Once this goal has been identified, as well as the degree of liberalization needed to achieve it, the government's role is to formulate a program -- its timing, sequencing of components, and intensity.

A second role for government is to facilitate the transition. This consists of three types of activities. First, it is appropriate for the government to establish a social safety net for those who are the most severely hurt by reforms. It does not, however, appear appropriate to single out those who are adversely hurt by one type of reform, such as trade liberalization, and compensate them overly generously.

Another role for government in the transition is to reduce the constraints to the smooth reallocation of resources. New investments need to be made in new and old places, and workers have to be trained and shifted to other sectors or other parts of the country. The government should certainly not attempt to direct all these shifts -- the socialist bloc experience has demonstrated clearly the failure of such planning. But there are improvements that governments make most efficiently relative to the private sector. One is to simplify customs and tax procedures. Another is to improve infrastructure, including roads, ports, and telecommunications. Also important are improvements in the education system, particularly, during the transition, in areas that quickly begin to demonstrate dynamism (e.g. textile engineering at a higher level, vocational and technical training in labor-intensive sectors of export strength.)

Finally during the transition, governments should engage in reciprocal negotiations in the international arena, in particular, through the GATT. While unilateral liberalization can yield significant benefits, there is little doubt that reciprocal negotiations will add to the gains of liberalization. Multilateral negotiations not only lower external barriers, allowing greater export expansion, they also can serve an important purpose internally. Reciprocal negotiations help the government to be perceived as an arbiter balancing the interests of those who will be temporarily hurt by import competition with the interests of those who will gain from exports. While everyone gains from liberalization in the long run (import competition stimulates efficiency, export expansion creates new jobs), during the transition it helps to show that efforts are being made to ensure that no one is hurt unfairly.

Role of Government in a Liberal Economy

What role remains for government as we approach the liberal range of policy options?

First, a few general remarks on the role of governments in an economy. What makes some economies more successful than others? In simple terms, the same things that make some individuals more successful than others: working hard, working smart, and working for the future. For the economy as a whole this means, expanding employment, investing in capital and education, striving to increase efficiency and productivity, and saving and reinvesting (wisely) a large part of GNP. But how this is done is also important. The appropriate economic role of governments is not to decide, direct, or command but rather to create an enabling environment in which individuals are free and motivated to work hard, smart, and for the future.

On the international aspect of economic policy, the basic role of government implies an economy open to the world market and based primarily on the freedom of private initiative and the discipline of the market- place, complemented by government actions of four types:[27]

- Assurance of a stable, clear, and credible legal framework for the enforcement of commercial-contractual obligations in a system of justice, with recourse and access by all parties.
- Maintenance of a stable macroeconomic environment, including a realistic exchange rate and fiscal and monetary stability.
- A readiness to take temporary actions, if needed, after liberalization to assist those seriously hurt by any unforeseen changes (including the effects of policy).
- Direct government actions to develop the physical, human, and social infrastructure needed to spur economic growth and increase productivity, but only in areas in which the government clearly has a comparative advantage over individual initiative.

Does this mean free-trade -- i.e., no tariffs, no customs regulations, and no laws against dumping by foreigners? It may mean that if that is the social consensus and the government reflects that view, but it need not. A moderate level of tariffs,[28] and some rules of operation on safeguards or similar

[27] The concrete measures that may follow from these fundamental principles in a particular case are elaborated in Havrylyshyn et al. (1990).

[28] The industrial country average is less than 5%, but their level of protection is higher than tariff rates alone would suggest, given the substantial increase in their use of non-tariff restrictions. This is in effect a step backward in liberalization that deserves the criticism it gets. Developing country liberalization measures should include all possible efforts to reduce these barriers, including reciprocal negotiations and political-diplomatic pressures that publicize the extent of this "New Protectionism."

measures are not necessarily very harmful.[29] What is to be avoided are high tariffs, extensive use of quotas and licensing, and highly distorted patterns of protection that greatly benefit some favored infant industries at a great cost to others.

In other words, what matters is that the governments perform well the four functions noted above and that any remaining trade regulations be low, clear, simple, transparent, limited, and fair in the sense that no sectors or industries enjoy greater favors than others. This means, simply, very limited and nondiscriminatory government intervention.

If we think of liberalization as a process over time, combining a shift from inward-oriented to outward-looking policies plus a reduction in the degree of government intervention, then not only is a quick leap to free trade a liberalization, but so is a relatively quick change in orientation and reduced intervention or a slower two-step movement, first shifting to outward orientation and then reducing interventions. The main difference is in the timing and sequencing. However, while the more gradual, two-step liberalization is feasible, it is difficult to implement without a loss of momentum and of credibility in the drive towards the goal of more liberal trade.

V. CONCLUSIONS: HOW DOES THE UNIQUENESS OF EASTERN EUROPE MODIFY THE PHASING OF TRADE LIBERALIZATION

Conclusions from the Experience Outside of Eastern Europe

We return here to the fundamental issues for trade liberalization posed at the outset, what can one say about the essential question: how, how much and how

[29] Antidumping actions, however, tend to be used as protectionist devices without the safeguards of "safeguard" provisions, and are thus best avoided. See Finger (forthcoming).

<u>fast to liberalize?</u> The results from experience outside of Eastern Europe indicate that speed is important, and one should surely go as fast as political circumstances allow, to preclude the possibility of opposition building up and reversing the process. But what truly underlies the vaunted benefits of speed is the fact that a Big Bang automatically meets the following essential criteria of successful economic reforms:

-- they are a comprehensive package

-- the various elements are coordinated

-- the program is preannounced with a clear statement of its content, time, and goal

-- the above three elements together give CREDIBILITY.

If these characteristics can be attained in a gradual program then gradual is not risky. Otherwise gradualness does risk reversal, opposition, hesitancy -- that is repetition of the past failures of partial reforms. No amount of historical evidence or economic analysis can tell us how big that risk is. But it is telling only a handful of cases exist of successful and gradual liberalization-- and there is by no means unanimous agreement about this interpretation -- while the instances of failed partial and gradual reform are numerous.

<u>Uniqueness of the East European Economies: Implications for The Pace and Phasing of Trade Liberalization:</u>

The above discussion has included references to East European experiences where it was applicable to certain "lessons" from attempts at trade liberalization. Here we wish to systematically discuss the question of how unique is East Europe, and consequently how would the lessons from experience need to be modified in the Eastern European context?

Certainly, these economies are different in a number of important respects from developing countries which have attempted trade liberalization: (1) the degree of distortion in relative prices is dramatically greater; (2) factor markets function much more poorly if at all; (3) the domestic production structure is considerably more concentrated than in non-socialist economies; (4) the external trade regime has been dichotomized into a hard currency and a transferable rouble region (the CMEA, which has been discussed above); (5) the political support for market based reform, including trade reform, is relatively strong, at least for the near future; and, what is probably the most important distinction, (6) the extent of state ownership is much greater, generally encompassing more than 90 percent of industrial production. In general, these differences tend to indicate that the reforming socialist economy should accelerate rather than retard the pace of and phasing of trade liberalization.

While importing a rational set of relative prices into the economy as a signal to resource reallocation is an important feature of trade liberalization everywhere, due to differences (1) and (2) the benefits of the liberalization in this regard will be much larger. Despite the fact that in many cases relative prices in socialist economies are bizarre by the standards of world markets, and factor markets in Eastern Europe remain in their infant stage, making it virtually impossible to establish a rational set of relative prices in a closed economy, the reforming socialist economy can establish appropriate relative prices for traded goods through trade liberalization. Thus, there is a growing consensus (for example, Lipton and Sachs, 1990; and Fisher, 1990) that for these reasons trade liberalization is more important and will provide considerably more benefits in reforming socialist economies.

Similarly, the concentrated nature of the domestic production structure implies that domestic competition will be weak, so that distortions due to monopolistic pricing will be high. More importantly, there is considerable pressure in Eastern European countries to divest enterprises into smaller entities; without import competition that pressure may be irresistible and in many cases appropriate; but as mentioned above, given the relatively small size of the economies, in many cases this will lead to a loss of economies of scale or scope. Thus, rapid liberalization will not only add competition, it may also prevent the loss of productive efficiency.

Given the strong political support for market reform, including trade reform, it may be wise to seize the moment and rapidly liberalize. If trade reform is phased in over a number of years, political forces in opposition to the reform may organize to stop the process. The outcome may be an economy with a highly distorted pattern of protection.

On the other hand, the long run hope of Eastern European countries is to integrate themselves into the western trading community, and in particular into the EC. Although there has been no formal application for EC membership, public statements to this effect have been made by leaders of some Eastern European countries. The EC has not formulated an official position in response, but the EC discussions on association agreements with Poland, Hungary and the Czech and Slovak Republic have already begun which will probably become effective in 1992. For the first couple of years, the Eastern European countries would not be called upon to make reciprocal concessions toward the EC, i.e., the agreements would be like the cooperation agreements that the EC maintains with many Mediterranean countries such as Morocco and Tunisia, which grant tariff free access to the EC markets for non-sensitive products without similar EC access to the markets of the LDCs.[80] Eventually, however, reciprocal reduction of trade barriers and some harmonization of laws would be required.

Consequently, pressure to liberalize as part of Association agreements with the EC will likely induce a liberalization over a 10-15 year period; this was the pattern for Spain, Greece and Portugal. In certain sectors in which the EC is protectionist, notably agriculture, pressure from the EC will not assure an efficient system. Moreover, as the case of Greece shows, the long term liberalization was not a guarantee of an undistorted growing economy. Rather than allow adjustment in response to changes in relative prices dictated by trade liberalization, Greece choose to subsidize or nationalize a number of sectors, resulting in large budget deficits and a reduction of growth. Thus, despite the external pressure of the EC, a rapid liberalization appears preferable, but these countries are in a better position than most to successfully achieve a long slow liberalization due to their emerging relationship with the EC.

The principle hesitation one must have regarding rapid trade liberalization in Eastern Europe is the lack of widespread privatization. As some sectors contract due to a decline in relative prices, there will be opportunities in others. Without adequate numbers of entrepreneurs it is difficult to see who will seize the opportunities provided by the changing relative prices and who will thereby provide employment and new output. That is, the supply response will likely be muted. Moreover, theoretical considerations of how decentralized firms without private owners respond to different price signals indicate that in some

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[80] The agreements are likely to have separate arrangements for the "sensitive" products like textiles and apparel, steel and agricultural products.

forms, the output response is perverse (Ward, 1958 showed that in the labor managed firm, output may decrease in response to a price increase). Although not existing in its pure Yugoslavian form, there is a strong element of labor control in many decentralized Eastern European firms. Labor controlled firms tend to pay high wages and decapitalize the firm which has required some Eastern European governments (Poland and Hungary for example), which attempted decentralization without private ownership, to reimpose central controls on the wage rate increases and on investment.[81] This would seem to imply that the transition costs might be much larger than in market oriented economies. The importance of privatization extends beyond trade liberalization to the effectiveness of decontrol of prices, of financial market reform and to all reforms that involve improving the price signals in the economy. All these reforms are likely to unravel and fail without privatization because they depend for their effectiveness on the firm responding appropriately to the improved price signals. Thus, privatization must proceed rapidly.

Although a number of Eastern European countries are prepared to undertake trade liberalization (and other price reforms) rapidly, most appear, for either political or institutional reasons, to desire a phased privatization process. The clear first best policy is to implement both reforms and rapidly. The question which remains, however, is that in this second best world, and given that even rapid privatization schemes envisage at least a year or two until proper incentives are established for the large enterprises, whether: (1) trade (and other) reforms must await the implementation of widespread privatization; or (2) if privatization of small and medium enterprises starts immediately and it is

[81]These facts indicate that true decentralization without owners is likely to be counterproductive. See Hinds or Saldanha for an elaboration.

anticipated that significant privatization of large enterprises will occur within two or three years it is better to undertake reforms that improve the price signals such as trade liberalization. This is a question of the optimal transition in a second best world.

There a number of risks in the first approach, both economic and political economic. First, the economic. A strong case has been made that decentralization without private ownership is likely to be counterproductive. But if privatization of the small and medium enterprises occurs very rapidly, and if free entry of private firms is allowed anywhere, then a significant amount of resource allocation will very quickly be determined by private owners, even if the large state enterprises remain temporarily non-private. Clearly resource allocation decisions by the private firms will be dramatically improved by improved price signals, and this includes the formation of large companies by foreign investors.

Moreover, even though the state owned enterprises will not respond as rapidly or efficiently as private firms to an improved set of price signals, their performance will likely improve under a regime of improved price signals and tightened budget constraints. Many of the Polish state companies made an impressive number of changes during 1990 in response to the changed price signals. This has involved developing new product lines and markets, including selling components of a production process to Western firms, and acquiring Western joint venture partners for marketing and technology skills.[82] Consider new investment. The logic of the argument that improved price signals are irrelevant for the state owned enterprises, would allow, say Poland, to invest in greenhouses to produce bananas, at massive cost to the economy. Consequently,

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[82] See Jorgensen, Gelb and Singh (1990). Jeffrey Sachs has also reported similar behavior among Polish firms.

it is preferable to have investment choices based on the best set of relative prices and costs available, which as stated above, can only be obtained in the transition in Eastern Europe through trade liberalization.

Moreover, trade liberalization may facilitate and therefore be complementary to the process of privatization. As has been emphasized by Winiecki (1990), privatization will be resisted by the vast bureaucracy which receives rent from state ownership.[33] As the privatization process begins, new private firms will require inputs, which if supplied domestically, will be supplied by state enterprises. If firms do not have access to imports, those in the state bureaucracy who oppose privatization will be able to sabotage it by denying important inputs to the private firms. If the economy is open, however, inputs can be imported, and the private firms can expand more rapidly.

On the political economy side, note that privatization is a necessary, but not a sufficient condition for the creation of an efficient market economy. There are many ways to distort price signals and retard growth in predominantly private economies (including trade protection). Privatization will install capital owners who will collaborate with workers in the preservation of rents. This may make it more difficult to remove the trade restrictions, especially if, by assumption of the argument trade reform is presently possible. Given the political momentum for reform, it appears judicious to take whatever economic reform that is politically possible in the present, for fear that it will not be possible to obtain later.

[33]Formerly this was controlled by the Communist party "nomenklatura" who appointed party "apparatchiks" to relatively well paid positions in the economic bureaucracy, where the latter may include company managers. These bureaucrats in turn distributed rents to the nomenklatura in various ways such as the allocation of goods in excess demand at the grossly undervalued prices. See Winiecki, among others, for details. While the Communist party has lost control in most of East and Central Europe, an economic bureaucracy remains, many of whom will attempt to protect rents.

Another risk of the first approach is that if one awaits a full package of politically acceptable reforms, the impatience for the start of the reform process may result in a loss of confidence in the government. For example, despite the fact that the government of Bulgaria had plans for widespread price and trade reforms, it took almost no action on its reform program in 1990, demanding a wider political consensus. At the end of November 1990, the government was forced to resign and new elections were scheduled for the spring of 1991.

Poland is a test case for the second approach. It undertook a Big Bang approach to trade liberalization and other reforms, while at the same time embarking on a multifaceted phased approach to privatization. Free entry of new private firms was permitted, which resulted in the net creation of over 25,000 small and medium scale private enterprises in 1990.[84] In addition, Poland's Ministry of Ownership has prepared a program that emphasizes rapid privatization, with a view to eventually privatizing 8,000 large state owned enterprises.[85] Elected to the Presidency in a landslide in December 1990, Lech Walesa pledged in the campaign to accelerate the privatization process. If successful, Poland will demonstrate the feasibility of the path of undertaking trade and price reform with a multifaceted phased privatization program.

In summary, rapid implementation of privatization and trade liberalization is the best approach. Trade and other reforms to improve price signals will ultimately be unsuccessful if not accompanied by widespread privatization. It appears best, however, to embark on trade liberalization immediately, even if a

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[84] Statement of S. Gromulka at the Conference on Enterprise Restructuring in Eastern Europe, The World Bank, December 14, 1990.

[85] Government of Poland, Ministry of Ownership, "Privatization Program," October 26, 1990.

program of privatization will be phased in over time. Delay in a trade liberalization program runs the risk of creating a permanently protected economy. Until wide privatization is achieved, however, one should expect that the supply response and resource reallocation that is desired from trade liberalization will be less vigorous in the state owned enterprises; and it will be necessary to maintain certain central government checks on the perverse behavior of decentralized firms without owners (such as wage rate controls). On the other hand, supply response can be expected to be strong from the small and medium firms which can be privatized almost immediately, and from firms created from foreign direct investment. Moreover, improved price signals can be expected to improve resource allocation even in the state owned enterprises, and trade liberalization may stimulate or be complementary to the process of accelerating privatization.

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TABLE A. COMPOSITION AND DIRECTION OF EXPORTS FOR SELECTED CMEA COUNTRIES
For Most Recent Data Available (1987-1989)

BULGARIA	OECD	SOCIALIST	LDC
Raw materials	37%	13%	25%
Fuels	13%	6%	7%
Equipment	25%	68%	47%
Manufactures	25%	12%	21%
CZECHOSLOVAKIA	**OECD**	**SOCIALIST**	**LDC**
Raw materials	20%	4%	14%
Fuels	3%	3%	4%
Equipment	28%	65%	44%
Manufactures	49%	29%	39%
HUNGARY	**OECD**	**SOCIALIST**	**LDC**
Raw materials	31%	20%	13%
Fuels	8%	1%	2%
Equipment	26%	57%	60%
Manufactures	35%	22%	26%
POLAND	**OECD**	**SOCIALIST**	**LDC**
Raw materials	34%	6%	17%
Fuels	15%	8%	11%
Equipment	22%	61%	40%
Manufactures	29%	29%	32%
ROMANIA	**OECD**	**SOCIALIST**	**LDC**
Raw materials	7%	23%	12%
Fuels	45%	0%	8%
Equipment	12%	59%	47%
Manufactures	36%	18%	33%
USSR	**OECD**	**SOCIALIST**	**LDC**
Raw materials	17%	22%	16%
Fuels	57%	41%	40%
Equipment	9%	33%	24%
Manufactures	17%	5%	21%
YUGOSLAVIA	**OECD**	**SOCIALIST**	**LDC**
Raw materials	19%	7%	13%
Fuels	3%	0%	0%
Equipment	29%	57%	45%
Manufactures	50%	36%	41%

TRADE CATEGORIZATIONS
Raw materials include food, agricultural and other primary goods. Fuels include mineral and other fuels and related products. Equipment includes machinery, transportation and other equipment, and chemicals. Manufactures include those categorized by material as well as miscellaneous.

SOURCES
Exports to OECD and LDC: COMTRADE System, World Bank as reported by importing countries, except for exports of Hungary and Yugoslavia which are reported by exporter. Exports to socialist countries are World Bank estimates based on CMEA data provided to various World Bank Country Economic Missions and shown in most recent country reports.

TABLE B. LABOR FORCE COMPOSITION
For Most Recent Data Available 1986-1987

	Agriculture & Mining	Manufacturing & Utilities	Construction	Services
United States	4%	20%	7%	70%
Japan	8%	25%	9%	58%
France	7%	23%	7%	63%
Italy	11%	22%	9%	58%
United Kingdom	3%	23%	6%	68%
W. Germany	6%	33%	7%	55%
Group Average	7%	25%	7%	61%
Greece	28%	21%	6%	45%
Ireland	16%	20%	7%	57%
Portugal	23%	25%	9%	43%
Spain	16%	23%	8%	53%
Group Average	21%	22%	7%	50%
Korea	23%	27%	6%	44%
Malaysia	32%	16%	6%	45%
Singapore	1%	27%	8%	64%
Thailand	64%	10%	3%	24%
Group Average	30%	20%	6%	44%
Bulgaria	21%	35%	9%	36%
Czechoslovakia	16%	35%	8%	41%
Hungary	21%	31%	7%	41%
Poland	32%	25%	8%	34%
Romania	29%	37%	7%	27%
USSR	19%	29%	9%	43%
Yugoslavia	7%	41%	9%	43%
Group Average	21%	33%	8%	38%

SOURCE: International Labour Organization, Year Book of Labour Statistics, Geneva 1988.

TABLE C. EDUCATION RATES

Percentage of total population achieving various levels of education per year for the year 1987 or that most recently available

	Tertiary Graduation Four-year Programs		Secondary Education (four years**)		Primary Education
	Non-vocat.	Vocational*	Non-vocat.	Vocational	(Grade V***)
Canada	0.48%	0.07%	1.49%		1.43%
United States	0.47%	0.09%	1.37%		1.33%
Japan	0.23%	0.10%	1.07%	0.15%	1.42%
France	0.36%	0.03%	1.34%	0.40%	1.42%
Italy	0.13%	0.02%	1.58%	0.84%	1.29%
Spain	0.22%	0.03%	0.97%	0.35%	1.93%
West Germany	0.18%	0.06%	1.06%	0.61%	0.95%
Korea	0.29%	0.12%	1.23%	0.26%	1.83%
Malaysia	0.05%	0.01%	1.15%	0.40%	1.42%
Singapore	0.12%	0.04%	1.87%	0.84%	1.29%
Thailand	0.01%	0.00%	0.40%	0.35%	1.93%
Bulgaria	0.11%	0.08%	0.11%	0.15%	1.71%
Czechoslovakia	0.10%	0.11%	0.21%	0.31%	1.72%
Hungary	0.09%	0.03%	0.25%	0.71%	1.68%
Poland	0.12%	0.06%	0.22%	0.72%	1.74%
Romania	0.05%	0.08%	0.05%	0.62%	
USSR	0.16%	0.11%	0.82%	0.15%	1.64%
Yugoslavia	0.09%	0.04%	1.29%	0.52%	1.53%

SOURCE: 1989 UNESCO Statistical Yearbook.

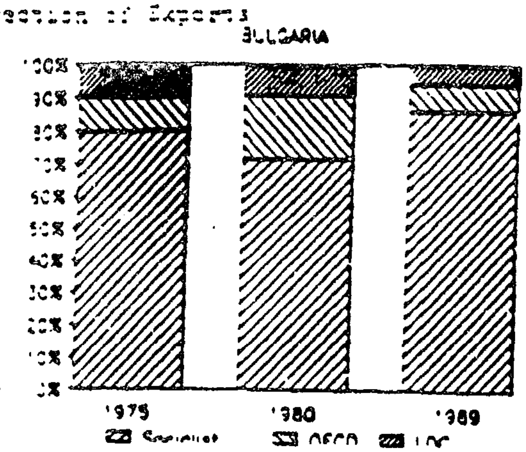
* Vocational education is defined as arts and crafts, engineering and architecture, services trades, and agriculture. Non-vocational includes all of the sciences and humanities, law, education, and business.

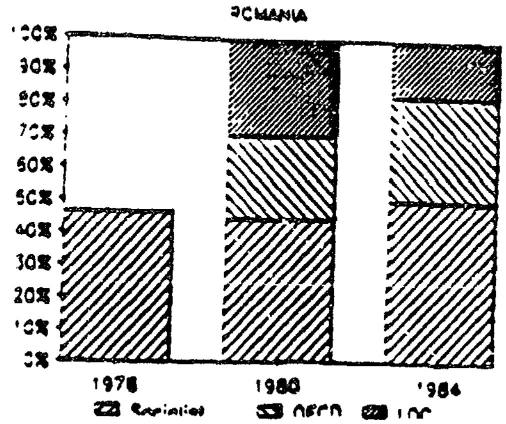
** Percentage of total population enrolled in fourth secondary year, third year in the case of Italy.

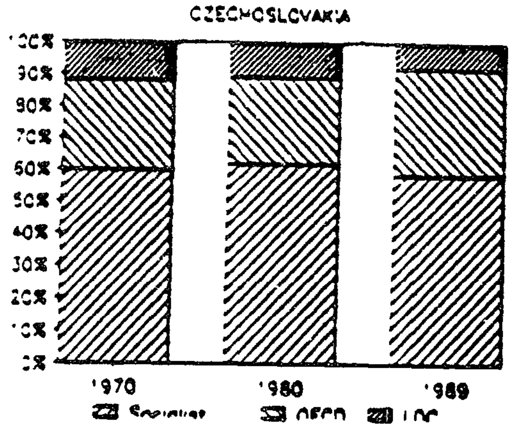
*** Percentage of total population enrolled in fifth grade, fourth grade in the case of Yugoslavia and West Germany.

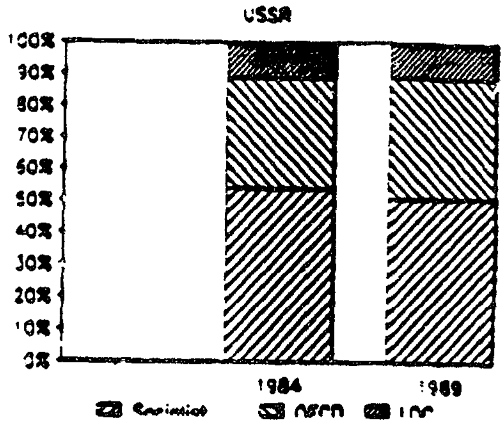
Tertiary education rates include lower levels of post-secondary education. Secondary education rate includes vocational students.

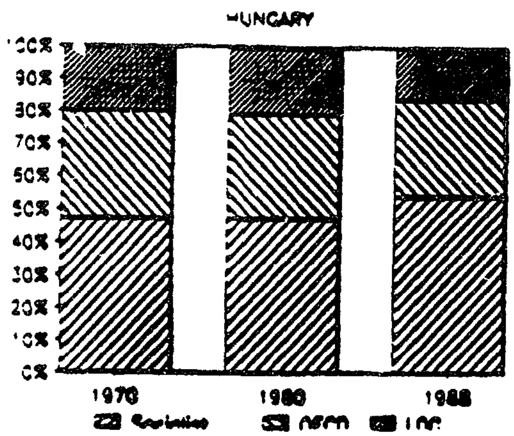
Direction of Exports

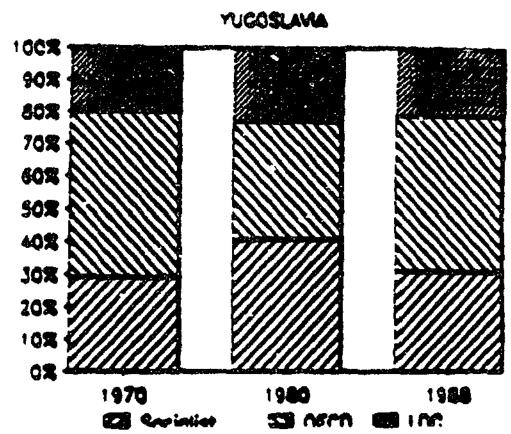












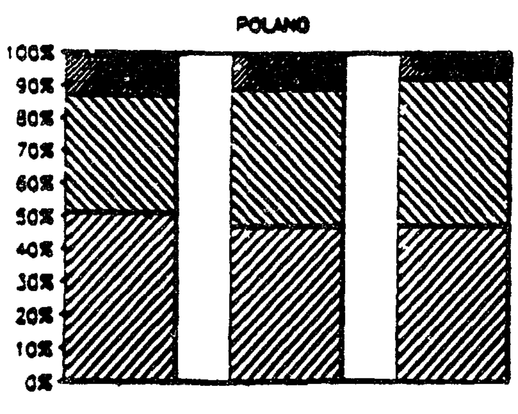
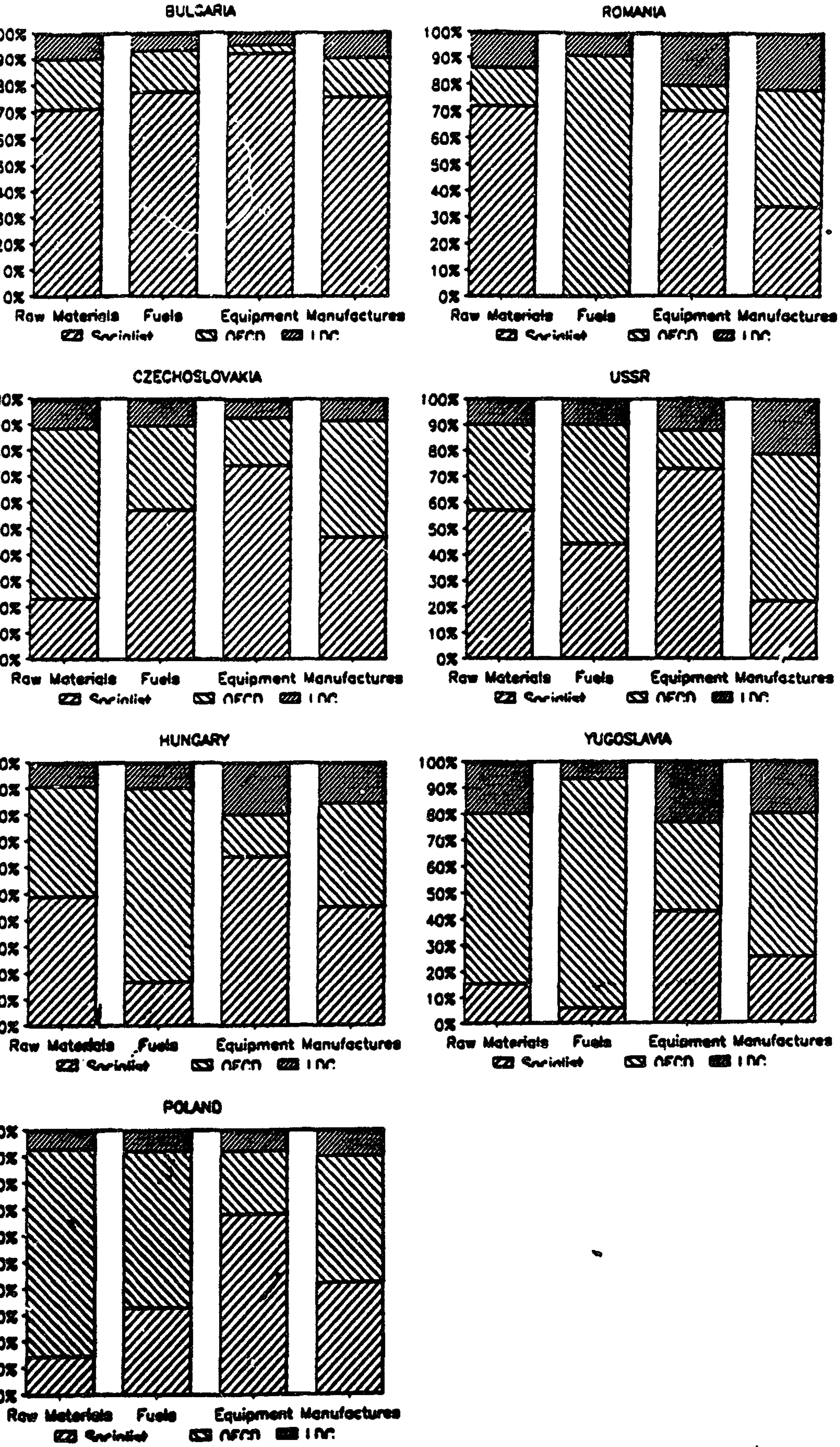


CHART 3

Direction of Trade by Commodity Group



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